

**Letter of Findings: 01-20110051
Individual Income Tax
For the Years 2005 through 2008**

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ISSUES

I. Business Expenses – Individual Income Tax.

Authority: Commissioner v. Heininger, 320 U.S. 467 (1943); Kornhauser v. U.S., 276 U.S. 145 (1928); IC § 6-8.1-5-1(c); IC § 6-8.1-5-4; Edwin's, Inc. v. U. S. 501 F.2d 675 (7th Cir. 1974); Adler v. C.I.R., T.C. Memo. 2010-47, 2010 WL 934267 (U.S. Tax Ct., 2010); Alemasov v. C.I.R., T.C. Memo. 2007-130, 2007 WL 1484527 (U.S. Tax Ct., 2007); Pepsi-Cola Bottling Co. of Salina, Inc. v. C. I. R. 528 F.2d 176, 179 (10th Cir. 1975); Charles Schneider & Co., Inc. v. C.I.R., 500 F.2d 148 (8th Cir. 1974); Charles McCandless Tile Service v. U. S., 422 F.2d 1336 (Ct. Cl. 1970); [45 IAC 3.1-1-66](#); I.R.C. § 162; I.R.C. § 6001; Treas. Reg. § 1.162-1; Black's Law Dictionary (7th ed. 1999).

Taxpayer challenges the Department of Revenue's decision disallowing business expenses claimed by Taxpayer's S-Corporations.

II. Vehicle Expenses – Individual Income Tax.

Authority: IC § 6-8.1-5-1(c); Adler v. C.I.R., T.C. Memo. 2010-47, 2010 WL 934267 (U.S. Tax Ct., 2010); Nicely v. C.I.R., T.C. Memo. 2006-172, 2006 WL 2380958 (U.S. Tax Ct., 2006); Nitschke v. C.I.R., T.C. Memo. 2000-230, 2000 WL 1053852 (U.S. Tax Ct., 2000); I.R.C. § 274(d); I.R.C. 280F(d)(4)(A)(i).

Taxpayer argues that the Department of Revenue incorrectly disallowed expenses associated with the purchase, maintenance, and depreciation of two automobiles.

III. Uncollectible Accounts – Corporate Income Tax.

Authority: IC § 6-8.1-4-2(a); IC § 6-8.1-5-1(c).

Taxpayer maintains that it was entitled to "write-off" on its S-Corporation's 2008 Indiana income tax return amounts of money which it deemed uncollectible.

STATEMENT OF FACTS

Two individual taxpayers filed joint Indiana income tax returns for 2005 through 2008. For the sake of simplicity, the two individuals are hereinafter simply referred to as "Taxpayer."

The Indiana Department of Revenue (Department) conducted an audit review of the returns and business records of two S-Corporations. The two corporations are designated here as "Pharmacy Business" and "Consulting Business."

Taxpayer owns 100 percent of both Pharmacy Business and Consulting Business. As "S-Corporations," the audit report noted that "all items of S Corporation income and expense flow through to the corporation shareholder and are taxed at that reporting level."

The adjustments on the Pharmacy Business and Consulting Business's returns affected Taxpayer's potential tax liability. Taxpayer submitted a protest challenging the resulting assessments. An administrative hearing was conducted during which Taxpayer's representatives explained the basis for the protest. This Letter of Findings results.

I. Business Expenses – Individual Income Tax.

DISCUSSION

As noted above, Taxpayer objects to certain adjustments made by the Department to the original S-Corporation returns submitted by Pharmacy Business and Consulting Business.

A. Pharmacy Business.

Pharmacy Business provides prescription medicine and related supplies to patients in long-term care facilities. Payments are predominately received from Medicare and Medicaid. Taxpayer states that it also receives payments from other "third party payers" and from individuals making "co-payments." Pharmacy Business also sells some supplies to the long-term care facilities. In addition, Pharmacy Business repackages medicine, hires individuals to deliver the medicine, and provides medical record services on behalf of the long-term care facilities.

Pharmacy Business elected to be treated as an S-Corporation. Taxpayer owns 100 percent of Pharmacy Business and "is taxed on his distributive share of income from the [Pharmacy Business]."

An S corporation normally does not pay income tax. [45 IAC 3.1-1-66](#), states that, "Corporations electing Subchapter S status under Internal Revenue Code § 1372... are exempt from adjusted gross and supplemental net income tax on all income except capital gains...." Rather than taxing the income at the business level, the S corporation's income is passed through to the shareholders. The shareholders then must report the income on their own income tax return. [45 IAC 3.1-1-66](#) states that, "Subchapter S corporation shareholders are taxed on

their distributive shares of income at the individual income tax rate." This is the dilemma in which Taxpayer finds himself; because certain of the Pharmacy Business's deductions were disallowed, additional taxable income flowed through to Taxpayer as the Pharmacy Business's single shareholder. It was this additional "flow through" income which led to the imposition of Taxpayer's additional individual income taxes.

The issue is attributable to amounts claimed by Pharmacy Business as "ordinary and necessary" business expenses. Under Treas. Reg. § 1.162-1, a taxpayer, whether a corporation, an individual, partnership, or a trust or estate, generally may deduct from its gross income the ordinary and necessary expenses of carrying on a trade or business that are paid or incurred during the tax year.

Taxpayer's additional, individual income taxes flowed through as a result of certain adjustments made on Pharmacy Business's return. At the outset, it should be noted the audit concluded that Pharmacy Business had not filed corporate income tax returns for the three of the four years at issue.

The audit took note of the fact that business expenses are routinely generated by S Corporations and that – as a separate reporting entity from its owner – Pharmacy Business is required to determine its taxable income that results from its gross income less allowable business expenses. Nonetheless, not all expenses routinely generated by the S Corporations are deductible business expenses. The audit report cited to I.R.C. § 162 authority for the rule that "deductible business expenses" "must be ordinary and necessary to be deductible as a business expense." In making its decision, the audit further cited to IRS Publication 535 when it defined "ordinary" as an expense that is common and accepted in a taxpayer's particular industry. Similarly, a "necessary" expense is one that is helpful and appropriate for the taxpayer's trade or business.

The Internal Revenue's technical definition is reinforced generally by Black's Law Dictionary 599 (7th ed. 1999) which describes "ordinary and necessary" as "an expense that is normal or usual and helpful or appropriate for the operation of a particular trade or business and that is paid or incurred during the taxable year."

The audit reviewed Pharmacy Business's claimed expenses and concluded as follows:

In the [Pharmacy Business's] case certain expenses were being taken that did not meet the ordinary and necessary requirements established for deductibility. As a result, the auditor has disallowed a deduction for these expenses in determining taxable income.

The Department's audit disallowed expense deductions between one and three million dollars for "contract labor fees" Pharmacy Business paid to Consulting Business – Taxpayer's other wholly owned S-Corporation. The audit noted that during the years under review, Consulting Business had no payroll and no physical location. In addition, the audit noted that Consulting Business's address was the same as Taxpayer's address.

The audit requested copies of the contracts and documents detailing and substantiating the services provided to Pharmacy Business, but was informed "that there was no written contract[s]." Additionally, the audit was informed that there had been "no invoicing of services between the two entities." Except for one of the four years under review, Pharmacy Business was Consulting Business's sole customer.

The audit noted that a significant number of payments – between \$800,000 and \$2,000,000 – received by Pharmacy Business as contract labor – were paid to a particular third party ("Third Party Nursing Home Owner") as "consulting fees." Taxpayer states that the Third Party Nursing Home Owner functioned as a "therapy provider." In reviewing these "consulting fees," the audit report notes that the Third Party Nursing Home Owner was the owner of a group of nursing homes which had an ongoing business relationship with Pharmacy Business. Under normal circumstances, Third Party Nursing Home Owner purchased prescription medicines from Pharmacy Business. The audit requested a copy of the contract which called for payment of the consulting fees but none was provided. Although a sample of invoices for one of the four years were available, the audit report stated that the invoices "gave no description or accounting of services performed or hours expended other than the general description 'management and marketing services.'"

Because of what it called "insufficient documentation," the audit disallowed the Pharmacy Business's payments made to Consulting Business because there was "no detail giving credence to the facts that payments were made in a manner that was ordinary in the [Pharmacy Business's] industry and that the payments were necessary to the taxpayer's business." Consequently, the business expenses were reclassified from "business deductions" to shareholder distributions and treated as contributions of capital on behalf of Taxpayer.

Taxpayer objects to the audit's conclusion and stresses that the payments made by Pharmacy Business to Consulting Business were legitimate (e.g. "ordinary and necessary") business expenses. Taxpayer points to several functions performed by Consulting Business on behalf of Pharmacy Business which purportedly buttress the claim that the payments were both "ordinary and necessary."

- Consulting Business was formed to provide consulting and marketing services.
- Pharmacy Business utilized Consulting Business "to increase its market share."
- Pharmacy Business utilized Consulting Business "as a method for [Pharmacy Business] to provide services to its competitors without them initially marketing [Pharmacy Business]."
- Hiring Consulting Business allowed Pharmacy Business to provide therapy services to third parties without the third parties knowing that it was Pharmacy Business that was providing the therapy.
- Hiring Consulting Business allowed Pharmacy Business to "become more competitive and grow its operation...."

Taxpayer states that, "[T]here was an arm's length negotiation with regard to pricing pharmaceuticals and with regard to the funds provided for therapy services." Taxpayer further claims that the Third Party Nursing Home Owner (therapy provider) "had received all the funds paid by consulting company as income and same were included in income an income tax was paid with regard to the same." However, it should be noted that Taxpayer has not provided any tangible evidence of the "arm's length negotiations" underlying the payments or that the therapy provider reported and paid tax on this income.

B. Consulting Business.

Similar to Pharmacy Business, Consulting Business is also an S-Corporation owned entirely by Taxpayer. Consulting Business does not have a business location other than Taxpayer's residence. At the outset of its argument, Taxpayer explained that Consulting Business "performed healthcare consulting services." However, the audit report indicated that Consulting Business had no payroll and no property presumably associated with the provision of these services.

The Department's audit found that Consulting Business had not filed income tax returns during the four years under audit. "As part of the audit process, the auditor secured income tax returns for the missing years and placed them on file with the Department." Several adjustments were made as described below.

The audit determined that a substantial majority of Consulting Business's income consisted of fees that were paid by Pharmacy Business. As noted above, the audit disallowed certain of the expenses claimed by that sister entity. The audit report indicates that because the Pharmacy Business's expenses were disallowed, "[T]he payment, originally reported by [Consulting Business] as income were reclassified per audit to shareholder capital contributions to [Consulting Business]."

In reviewing Consulting Business's expenses, the audit reiterated its position that deductible expenses must be "ordinary and necessary." The audit determined that some of the expenses were not "ordinary and necessary," that Pharmacy Business was its only customer, that Consulting Business had no payroll, that Pharmacy Business did not have a business location other than Taxpayer's home address, and that insufficient support was provided to establish the business purpose of the Consulting Business's expenditures.

The audit requested copies of contracts and other supporting documentation but "[t]here were no contracts or invoices provided in CY 2005-2007 supporting or detailing the expenses deducted for these consulting fee billings." Consulting Business provided accounts payable invoices for 2008 "but there was no detail in the billing description of the invoices beyond the general billing description of management and marketing services." According to the audit report "many of the expenditures in the expense transaction detail were not supported by... invoices or detail."

The audit "disallowed many of the expense deductions reported by [Consulting Business] in determining taxable income." These expense deductions were disallowed where a business purpose could not be determined and where the invoice detail did not support the expenditure as an "ordinary and necessary" business expense. Certain of the disallowed expenses follow:

Consulting Business claimed expense deductions ranging from about \$800,000 to \$2,800,000 for consulting fees. However there were no contracts or invoices supporting the payments of these fees. The majority of the fees were paid to Third Party Nursing Home Owner. It should be noted that Third Party Nursing Home Owner also contracted with Pharmacy Business for the regular purchase of prescription medicine.

During two of the audited years, Consulting Business claimed expenses for "contract labor." The audit was unable to review any documentation explaining these expenses because no documentation was available. The audit report noted the absence of a contract for these labor expenses and the absence of a corresponding federal 1099 form.

The audit also disallowed expenses claimed for office equipment, office supplies, professional fees, travel and entertainment, and "miscellaneous" because Consulting Business had no employees and no physical location other than Taxpayer's home residence.

The only business purpose that the audit could determine was that Consulting Business was set up to receive fees from Pharmacy Business and then redirect those fees to outside parties.

- Taxpayer objects explaining that Consulting Business was established for the "main purpose" of providing "consulting and marketing services for [Pharmacy Business]."
- Consulting Business's primary goal was to "reduce the responsibility of the pharmacy staff to just primary products and not the management of the therapists needed for treatment and application."
- Consulting Business was created to provide certain "specific niche services outside the primary pharmacy contract...."
- Consulting Business was intended to provide "education courses" which were to be funded by "various drug manufactures and carried during multiple pharmacy trade shows...."
- Consulting Business acted as a liaison between Pharmacy Business and an educational institution in which the educational institution was seeking to utilize Pharmacy Business as a teaching tool.
- Consulting Business worked with Third Party Nursing Home Owner to provide therapy services – on behalf of Pharmacy Business – for the benefit of nursing home patients.

Taxpayer explains the absence of contracts and invoices as follows:

Because of the specific service provided by [Consulting Business] to [Pharmacy Business] and their close relationship, [Consulting Business] has always had a handshake agreement. This is true with all business relationship [Consulting Business] has with other corporations or entities. In order for [Consulting Business] to keep costs down and because of the unusual workflow, [Consulting Business] has not since its creation used written contracts or agreements.

Pharmacy Business claimed expenses of approximately \$9,400,000 which the audit concluded were not "ordinary and necessary." Consulting Business claimed approximately \$8,150,000 which was also disallowed.

In making its legal argument, Taxpayer cites to *Commissioner v. Heininger*, 320 U.S. 467 (1943), as buttressing its argument that the expenses claimed by both Pharmacy Business and Consulting Business were "ordinary and necessary." In that case, the Court found that the expenses incurred by a mail order dentist in an effort to enjoin enforcement of a post office fraud order, although ultimately unsuccessful, resulted in the dentist keeping his business alive for two years, were "ordinary and necessary business expenses" and were deductible from income. *Id.* at 471-72. Taxpayer also cites to *Kornhauser v. U.S.*, 276 U.S. 145 (1928), in which the Court held that attorney fees for defending an accounting action brought by a former partner were deductible from gross income as an "ordinary and necessary business expense." *Id.* at 153.

It should be noted that IC § 6-8.1-5-4 requires that Taxpayer maintains the records necessary to determine whether or not that Taxpayer owes tax.

(a) Every person subject to a listed tax must keep books and records so that the department can determine the amount, if any, of the person's liability for that tax by reviewing those books and records. The records referred to in this subsection include all source documents necessary to determine the tax, including invoices, register tapes, receipts, and canceled checks.

(b) A person must retain the books and records described in subsection (a), and any state or federal tax return that the person has filed:

- (1) for an unlimited period, if the person fails to file a return or receives notice from the department that the person has filed a suspected fraudulent return, or an unsigned or substantially blank return; or
- (2) in all other cases, for a period of at least three (3) years after the date the final payment of the particular tax liability was due, unless after an audit, the department consents to earlier destruction.

In addition, if the limitation on assessments provided in section 2 of this chapter is extended beyond three (3) years for a particular tax liability, the person must retain the books and records until the assessment period is over.

A taxpayer claiming "ordinary and necessary" business expenses must provide records and documentation substantiating the legitimacy of those claimed expenses. In *Adler v. C.I.R.*, T.C. Memo. 2010-47, 2010 WL 934267 at 10 (U.S. Tax Ct. 2010), the court reviewed a petitioner's claim that he was entitled to claim business expenses attributable to alleged use of vehicle as part of his wife's rubber-stamping home business. Petitioner provided only his wife's testimony, but did not provide any records or documentation substantiating the business use of the vehicle or other travel and business expenses. *Id.* The court pointed to I.R.C. § 6001 which "requires the taxpayer to maintain records sufficient to substantiate his claimed deductions." *Id.*

A taxpayer claiming "ordinary and necessary" business expenses has the burden of establishing that it is entitled to the claimed expenses. In *Alemasov v. C.I.R.*, T.C. Memo. 2007-130, 2007 WL 1484527 (U.S. Tax Ct. 2007), the court reviewed the petitioner's claim that business expenses shown on petitioner's tax return were paid or incurred during the taxable year and that the expenses were "ordinary and necessary" to the petitioner's business under I.R.C. § 162(a). *Id.* at *2. In reviewing petitioner's claims, the court noted that any deductions are a matter of legislative grace, and the petitioner had the burden of proving entitlement to any claimed deduction including the burden of substantiation. *Id.* (See also IC § 6-8.1-5-1(c), "The notice of proposed assessment is prima facie evidence that the department's claim for the unpaid tax is valid. The burden of proving that the proposed assessment is wrong rests with the person against whom the proposed assessment is made.")

A taxpayer claiming "ordinary and necessary" business expenses must establish that the claimed expenses were commercially reasonable. The court in *Edwin's, Inc. v. U. S.*, 501 F.2d 675 (7th Cir. 1974), reviewed the government's challenge to the District Court's determination, that salaries which the taxpayer paid to employees were reasonable for purposes of determining taxpayer's income tax liability. The court considered the following factors in upholding the district court's decision:

the type and extent of the services rendered; the scarcity of qualified employees; the qualifications and prior earning capacity of the employee; the contributions of the employee to the business venture; the net earnings of the taxpayer; the prevailing compensation paid to employees with comparable jobs; the peculiar characteristics of the taxpayer's business. *Id.* at 677.

In situation which closely related entities claim "ordinary and necessary" business expenses, the expense payments are subject to particularly close scrutiny. In *Charles McCandless Tile Service v. U. S.*, 422 F.2d 1336 (Ct. Cl. 1970), the court reviewed an issue presented which involved the extent to which amounts paid by petitioner during the years in question to its two principal officer-stockholders were deductible for tax purposes as reasonable compensation. *Id.* at 1337-38. The IRS had disallowed the expenses as "in excess of reasonable compensation." *Id.* at 1338. The court noted that in cases in which closely related parties are involved "close

scrutiny of payments is particularly warranted" and particularly where, "a closely held corporation and its officer-stockholders are involved." *Id.* at 1339. See also *Pepsi-Cola Bottling Co. of Salina, Inc. v. C. I. R.* 528 F.2d 176, 179 (10th Cir. 1975) ("[I]n determining reasonableness of compensation special scrutiny should be given to compensation paid by a corporation whose stock is closely held.") *Charles Schneider & Co., Inc. v. C.I.R.*, 500 F.2d 148, 152 (8th Cir. 1974) ("[W]here the corporation is controlled by the very employees to whom the compensation is paid, special scrutiny must be given to such salaries, for there is a lack of arm's length bargaining....").

Taxpayer cites to cases in which the taxpayer was entitled to deduct from its income expenses which were "ordinary and necessary" and – generally speaking – the Department has no quarrel with that entirely legitimate and long-held concept. However, the Department is unable to agree that Taxpayer has established that the Pharmacy Business and Consulting Business's claimed expenses were supported by the requisite documentation and records or that these expenses were either "ordinary" or "necessary." Taxpayer has claimed millions of dollars in business expenses based upon no more than a "handshake" agreement between these closely related parties; further, the justification for the expenses are described in the most general of terms. (The S-corporations provide, "marketing and consulting service," "specific niche services," "education courses," and "act as a liaison.") Under IC § 6-8.1-5-1(c), Taxpayer has the burden of establishing that the proposed assessment is wrong. In addition, under IC § 6-8.1-5-4, Taxpayer has the responsibility to maintain the books and records necessary to substantiate the claimed expenses. (See also I.R.C. § 6001 "Every person liable for any tax imposed by this title, or for the collection thereof, shall keep such records, render such statements, make such returns, and comply with such rules and regulations as the Secretary may from time to time prescribe."). In addition, the Department has failed to establish that the claimed business expenses were commercially reasonable. As noted in *Charles McCandless Tile Service*, payments of expenses between closely related entities – such as the business entities at issue here – warrant "close scrutiny."

FINDING

Taxpayer's protest is respectfully denied.

II. Vehicle Expenses – Individual Income Tax.

DISCUSSION

Consulting Business purchased vehicles and took deductions against its income for related expenses and depreciation. Consulting Business claimed expense deductions against its income and also claimed depreciation on the vehicles.

Finding that the "business purpose of these vehicles [was] not apparent," the audit disallowed the claimed expense. The audit report noted that Consulting Business did not have any employees and for three of the four years under review, Consulting Business only had one client.

In the case of Pharmacy Business, the audit found that Pharmacy Business made periodic payments to Taxpayer/Shareholder and classified the payments as "car allowance" payments. However, the audit found that Pharmacy Business "had no substantiation showing that these payments were reimbursements of car expense under an accountable plan where a mileage log or some other means of substantiation was maintained."

During the administrative hearing, Taxpayer provided "sample logs" for a period of time when one of the vehicles was driven by a "consultant pharmacist whose responsibilities included driving to facilities daily for review of the pharmacy services provided by [Pharmacy Business.]" The logs list day, date, destination, and mileage.

The law imposes "stringent substantiation requirements" on a taxpayer claiming expenses related to vehicle use. In *Adler v. C.I.R.*, T.C. Memo. 2010-47, 2010 WL 934267 at 10 (U.S. Tax Ct. 2010), the court reviewed the petitioner's claim that he was entitled to claim expenses related to the business use of a sports utility vehicle. The court disagreed with petitioner's claims finding that petitioner had failed to provide records sufficient to verify the claimed business use. *Id.* The court pointed to, I.R.C. § 274(d) which the court noted "imposes stringent substantiation requirements for claimed deductions relating to the use of 'listed property.'" which is defined under I.R.C. 280F(d)(4)(A)(i) to include passenger automobiles. *Id.* The court held that under I.R.C. § 280F(d)(4)(A)(i) any deduction claimed with respect to the use of a passenger automobile, such as Taxpayer's two vehicles, would be disallowed unless the Taxpayer is able to establish specified elements of the use by adequate records or by sufficient evidence corroborating the Taxpayer's own statements.

In establishing the claimed business expenses, "contemporaneous records" are crucial to corroborating the claimed expenses. In *Nicely v. C.I.R.*, T.C. Memo. 2006-172, 2006 WL 2380958 (U.S. Tax Ct. 2006), the petitioner sought review of the decision by the Internal Revenue Service that petitioner was not entitled to deduct certain claimed automobile expenses. *Id.* at *1. The court noted that the petitioner was required to satisfy the substantiation requirements set out in I.R.C. § 274(d) which states in part:

No deduction or credit shall be allowed... unless the taxpayer substantiates by adequate records or by sufficient evidence corroborating the taxpayer's own statement (A) the amount of such expense or other item, (B) the time and place of the travel, entertainment, amusement, recreation, or use of the facility or property, or the date and description of the gift, (C) the business purpose of the expense or other item, and (D) the business relationship to the taxpayer of persons entertained, using the facility or property, or receiving the gift.

The court cited to federal regulations for the proposition that contemporaneous expense records were of more probative value in determining the validity of the claimed expenses.

A taxpayer is required to substantiate each element of an expenditure or use by adequate records or by sufficient evidence corroborating his own statement. Section 274(d) contemplates that a taxpayer will maintain and produce such substantiation as will constitute proof of each expenditure or use referred to in section 274. Written evidence has considerably more probative value than oral evidence alone. In addition, the probative value of written evidence is greater the closer in time it relates to the expenditure or use. A contemporaneous log is not required, but a record of the elements of an expenditure or of a business use of listed property made at or near the time of the expenditure or use, supported by sufficient documentary evidence, has a high degree of credibility not present with respect to a statement prepared subsequent thereto when generally there is a lack of accurate recall. Thus, the corroborative evidence required to support a statement not made at or near the time of the expenditure or use must have a high degree of probative value to elevate such statement and evidence to the level of credibility reflected by a record made at or near the time of the expenditure or use supported by sufficient documentary evidence. *Id.* at *4 (Emphasis added).

The court held that petitioner had failed to carry its burden of establishing it was entitled to the deduction that petitioner claimed for the use of his automobiles. *Id.* at *5. The court noted that petitioner had failed to maintain contemporaneous records of the vehicle use but relied on documents prepared shortly before the trial. *Id.* at *4. See also *Nitschke v. C.I.R.*, T.C. Memo. 2000-230, 2000 WL 1053852 at 4 (U.S. Tax Ct. 2000) (rejecting petitioner's automobile expense deductions because petitioner's claims that the putative records were contemporaneous were not credible; the mileage records were based on estimates.)

Bearing in mind that IC § 6-8.1-5-1(c), requires Taxpayer to prove that the proposed assessment is wrong, the Department must disagree that the "sample logs" are sufficient to establish that it is entitled to the claimed expenses. The "sample logs" are neither contemporaneous nor complete and are unsupported by any independent, supporting documentation.

FINDING

Taxpayer's protest is respectfully denied.

III. Uncollectible Accounts – Corporate Income Tax.

DISCUSSION

Pharmacy Business filed a 2008 amended Indiana income tax return. The amended return showed a reduction in gross receipts of approximately \$670,000. The audit reviewed the amended return and reported as follows:

This reduction was reported as a return and allowance on the federal return 1120S. The explanation on the [Pharmacy Business's] amended federal return stated that the taxpayer's business was such that it bills Medicare and private insurance companies, and that it was bound by a contractual period of time to seek reimbursement. The taxpayer claimed that the amount deducted under the amended return filing was due to amounts billed after the contractual deadline had expired.

The audit requested documentation from Pharmacy Business to verify the amount deducted but concluded that "insufficient documentation was provided." The audit stated that "documentation is needed to show that accounts were written off through journal entry or other methods such that they were determined uncollectible in CY 2008." The report added that, "[S]ource documents establishing the amount deducted [are] necessary."

The audit report cited to IC § 6-8.1-4-2 for the authority to disallow Pharmacy's Business's \$670,000 reduction in gross receipts. In part, IC § 6-8.1-4-2(a) states as follows:

(a) The division of audit may:

- (1) have full prompt access to all local and state official records;
- (2) have access, through the data processing offices of the various state agencies, to information from government and private sources that is useful in performing its functions;
- (3) inspect any books, records, or property of any taxpayer which is relevant to the determination of the taxpayer's tax liabilities;
- (4) detect and correct mathematical errors on taxpayer returns....

Taxpayer objects stating the invoices issued by Pharmacy Business "had not been paid by December of 2008 and at that time [Pharmacy Business] determined that they would not be paid." Taxpayer states that it realized that certain of its customers "had no intention of making those payments" and that "due to the difficulty in collecting and the realization that the business relationship would not continue much longer it became clear in December of 2008 that [Pharmacy Business] would not see payment on the December 31, 2008 outstanding balance owed to them by [Third Party Nursing Home Owner]." Taxpayer explains that "[Taxpayer] had a final face to face meeting with [Third Party Nursing Home Owner]" and only then realized that Third Party Nursing Home Owner had no intention of ever paying these balances.

IC § 6-8.1-5-1(c) imposes on Taxpayer the burden of establishing that the proposed assessment is wrong. "The notice of proposed assessment is prima facie evidence that the department's claim for the unpaid tax is valid. The burden of proving that the proposed assessment is wrong rests with the person against whom the proposed assessment is made."

The Department is unable to agree that Taxpayer has established that the audit erred in making the adjustment as proposed. Nonetheless, the issue should be one which can be definitively resolved by means of a straightforward review of Taxpayer's own documents. Either Taxpayer can provide the necessary records or it cannot. The Department is prepared to permit Taxpayer a limited, 30-day opportunity to provide the books, records, journals necessary to establish that it is entitled the \$670,000 reduction in gross receipts.

FINDING

Taxpayer's protest is sustained subject to audit verification of the books, records, journals sufficient to establish the reduction in gross receipts.

SUMMARY

Subject to an audit review of supplementary documentation provided within 30 days of the issuance of this Letter of Findings as noted below, Taxpayer's protest of the audit's adjustment to its amended 2008 Indiana income tax return is sustained. In all other respects, Taxpayer's protest is denied.

Posted: 10/26/2011 by Legislative Services Agency

An [html](#) version of this document.